# Office of Chief Counsel Internal Revenue Service

# memorandum

CC:NER:MAN:TL-N-2689-00 CMBaerga/RLPeacock

date:

to: Chief, Examination Division, Manhattan Attn: Andrew Yeancates, Revenue Agent

from: District Counsel, Manhattan

subject:

Taxable years ending and and

U.I.L. No.:

162.07-01

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#### <u>Issue</u>

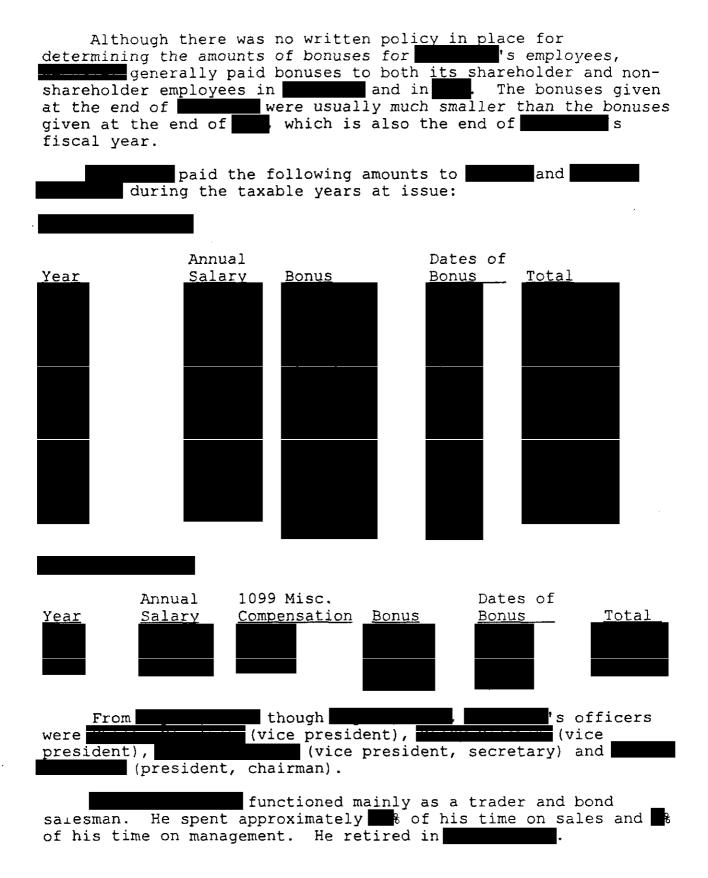
Whether to deduct the compensation it paid to for taxable years

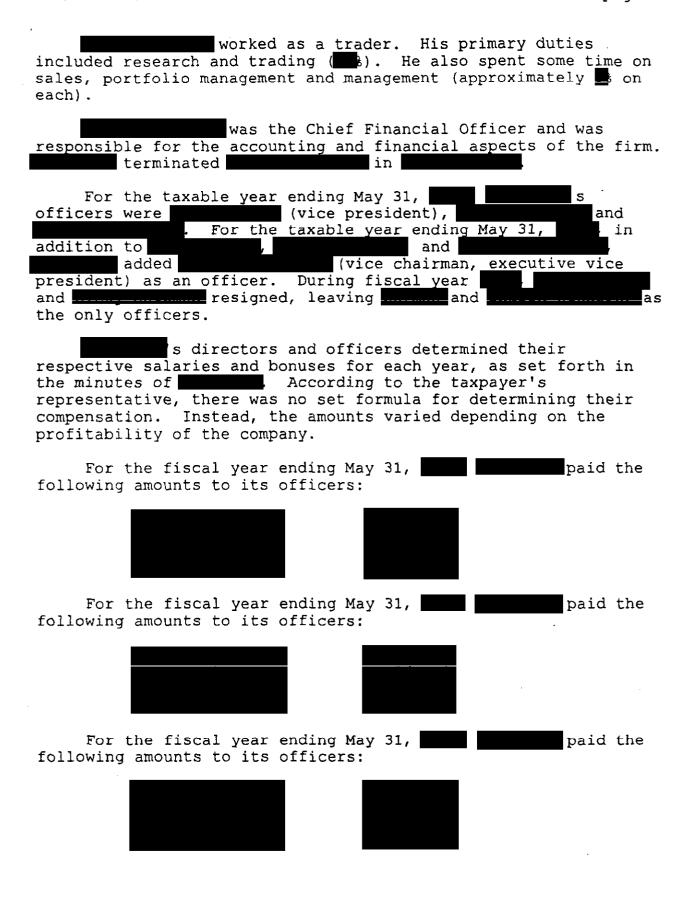
through and to for taxable years and //, pursuant to I.R.C. § 162(a). Background The Manhattan District is currently examining the income tax (E.I.N. for the taxable years ending May 31, though May 31, At issue is whether is entitled deduct compensation it the company's president and chairman, in paid to the amounts of \$ , \$ and \$ for taxable years respectively. Also at issue is whether is entitled to deduct compensation it paid to , who has held various positions at in the amounts of \$ and years and respectively. is a closely-held corporation registered as a broker/dealer with the Securities and Exchange Commission. Its main business activity is trading convertible bonds and underlying stocks for its own account. is based in New York. It was formerly known as and , a company founded and run by and When left the firm and retired in the midbecame the company's president. was 's president and chairman of the board during taxable years through provided the following information in response to an IDR: he graduated from and is years old. He has been involved with \_\_\_\_\_ and the securities industry for approximately years. His primary paid non-employee compensation in the amounts of \$ and \$ and \$ for taxable years and respectively. The Manhattan District concedes that these amounts of compensation were reasonable. revenue agent George Hasselgrin completed his audit of the taxable years ending May 31, and and . paid \$. for taxable years and respectively. According to Hasselgrin's RAR, he determined that \$ reasonable compensation for the for each year. did not receive any compensation from during and

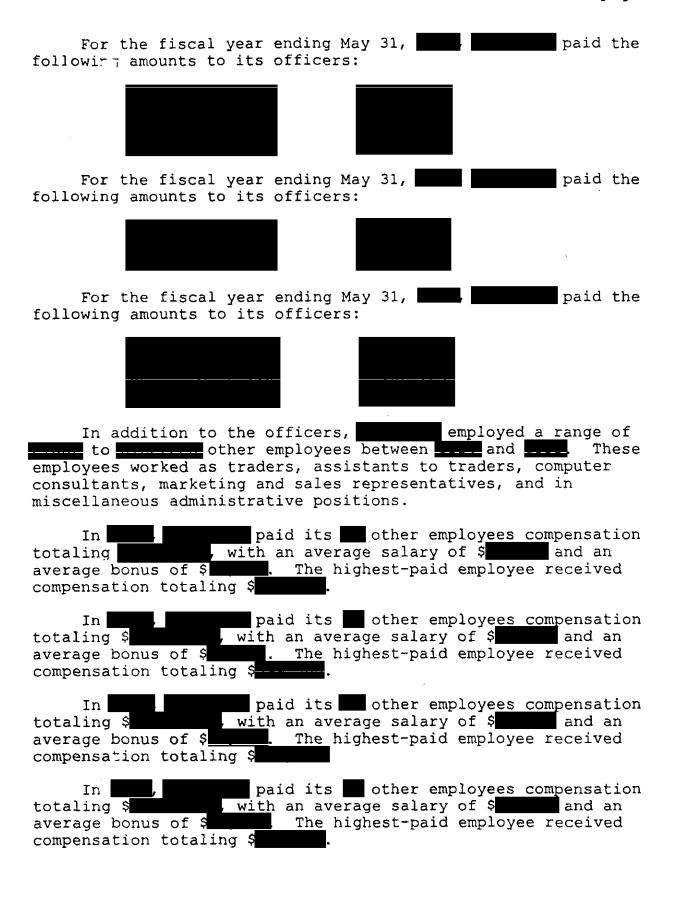
appeals officer Jerry Katz in Manhattan.

These years are currently assigned to

areas of expertise include trading, research, portfolio management, sales, legal, compliance and management. Prior to of his time researching, of his time on portfolio management, % of his time on sales, % of his time on software development and programming, and sof his time on management. After spent of his time trading, of his time researching, to of his time on portfolio management, to of his time on time on sales. The revenue agent who examined taxable years and however, determined that at least to 8 of the state of t activities. Regardless of the time he spends on each activity, works long hours, from approximately p.m. in the office, and an additional three hours at home each night. Both the revenue agent and the taxpayer's representative agree that is an expert in the securities industry, and that the success of is largely due to 's knowledge and efforts. to present, has held From the . According to a letter from several positions at , prior to was primarily responsible for "contacts and consulting." From in addition to maintaining contacts, she was the construction supervisor for s new office and the Human Resources Manager. From through her duties included, In In the early worked for as a trader and received a salary. After years of receiving a salary, she received no compensation from non-employee compensation for her consulting services in the amounts of \$ and \$ . \$ caxable years and and In paid paid compensation totaling \$ \_\_\_\_\_ part salary and part taxable years and non-employee compensation. In received compensation totaling \$ According to s representative, determined 's salary and bonuses for based on comparable salaries of other employees who became principals of at the same time.

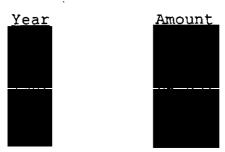






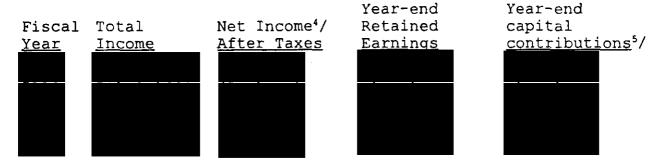
In paid its totaling \$ with an average bonus of \$ . The compensation totaling \$	standard employees compensation rage salary of \$ and an highest-paid employee received
totaling \$ , with an av	other employees compensation verage salary of \$ and an highest-paid employee received
For the taxable year ending May owned by (%), and ending May 31, the common (%), the common (%), Although percentages of ownership for the common (%).	( ), For the taxable year in stock was owned by ( ), and we do not have specific ne fiscal years ending May 31,
% to the common stock owning between to to the	ajority shareholder, owning between k, with the remaining officers common stock. During the common stock to the common stock t
In , sprefer following:	rred stock was owned by the
Owner	Number of Shares
Total	
As of the following:	's preferred stock was owned by  Number
Owner	of Shares
Total	
3/ shares of preferred stock to p	periodically redeemed ay taxes.

paid dividends on the preferred stock from through as follows:



From to present, has not paid dividends on the preferred stock. When asked why ceased paying dividends on the preferred stock, said that the corporation needed the money to remain competitive in the market and because the "nature of the business has changed."

On its Forms 1120, reported the following:



#### Analysis

A taxpayer may deduct ordinary and necessary business expenses, including "a reasonable allowance for salaries or other compensation for personal services actually rendered." I.R.C. § 162(a)(1). See also, Rutter v. Commissioner, 853 F.2d 1267, 1270-71 (5th Cir. 1988); Owensby & Kritikos, Inc. v. Commissioner, 819 F.2d 1315, 1322-23 (5th Cir. 1987). At issue here is whether the amounts of compensation paid to

<sup>4/</sup> As used here, the term "net income" refers to the "net income (loss) per books" as reported on the Schedules M-1 of 's Forms 1120.

The shareholders did not make any additional capital contributions from through Instead, the amount of the capital contributions decreased each year because the periodically redeemed preferred stock to pay taxes.

and and for the taxable years in question were reasonable.

The Second Circuit has considered the following five factors to determine if compensation paid by a corporation was reasonable:

(1) The employee's role in the taxpaying company, including the employee's position, hours worked and duties performed; (2) potential conflicts of interest, such as the ability to "disguise" dividends as salary; (3) the employer's compensation policy for all employees; (4) the character and financial condition of the company; and (5) comparison of the employee's salary with those paid by similar companies for similar services.

Rapco, Inc. v. Commissioner, 85 F.3d 950, 954 (2d Cir. 1996). See also, Normandie Metal Fabricators, Inc. v. Commissioner, T.C. Memo. 2000-102. No single factor is decisive, and the court should evaluate the factors from the perspective of an independent investor, i.e., "given the dividends and return on equity enjoyed by a disinterested stockholder, would that stockholder approve the compensation paid to the employee?"

Rapco, 85 F.3d at 954-55. See also, Dexsil Corp. v.
Commissioner, 147 F.3d 96, 100 (2d Cir. 1998); Normandie, T.C. Memo. 2000-102.

Courts differ on the factors they consider and on the value they place on each factor. For example, in addition to the five factors set forth above, courts have considered factors such as the employee's qualifications, the size and complexity of the business, prevailing economic conditions, the amount of compensation paid to the employee in previous years and a comparison of compensation to the business' gross income and net income. See, e.g., Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949) (considering nine factors); Kennedy, Jr. v. Commissioner, 671 F.2d 167, 73-74 (6th Cir. 1982) (considering 15 factors); Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983) (placing greater weight on fewer factors); Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999) (rejecting seven-factor test and holding that only "independent investor" test is applicable).

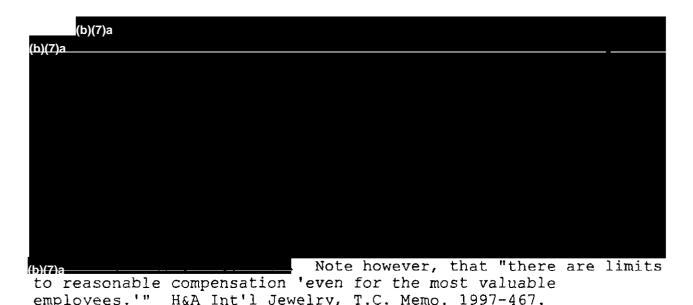
Because is located in New York, an appeal from the Tax Court would lie in the Second Circuit. Accordingly, the Tax Court would adhere to the five-factor test used by the Second Circuit in Rapco. As the Court explained, better judicial administration requires us to follow a Court of

Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and o that court alone."

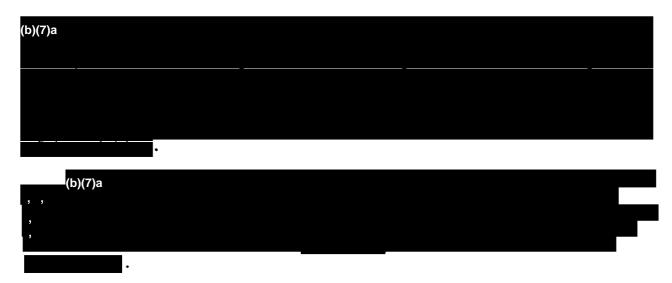
Golsen v. Commissioner, 54 T.C. 742, 757 (1970), aff'd on another issue, 445 F.2d 985 (10<sup>th</sup> Cir. 1971) (footnotes omitted). For purposes of this memorandum, therefore, we will evaluate the reasonableness of the amounts of compensation paid to and using the Second Circuit's five-factor test.

### 1. Employee's Role in Business

An employee's position, responsibilities, hours worked and "general importance to the success of a business" may justify his or her high level of compensation. <u>H&A Int'l Jewelry, Ltd. v. Commissioner</u>, T.C. Memo. 1997-467 (citing <u>Home Interiors & Gifts, Inc. v. Commissioner</u>, 73 T.C. 1142, 1158 (1980)).



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## 2. Potential Conflicts of Interest

If there are potential conflicts of interest between the corporation and the employees to whom it is paying compensation, such as the ability to disguise dividends, this suggests that the compensation is unreasonable. Rapco, 85 F.3d at 954; Normandie, T.C. Memo. 2000-102.

There are several potential conflicts of interest present here. (b)(7)a
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. As the Fifth Circuit explained,

[I]t obviously is in the tax interest of all parties to characterize the amounts distributed to shareholder/officers as compensation rather than as dividends. Corporations can deduct salaries and bonuses under § 162(a)(1) but obviously not dividend payments because they are profits, not business expenses. The concern is to prevent the distribution of corporate profits through the payment of unreasonably large salaries and bonuses to controlling shareholder/officers.

Rutter, 853 F.2d at 1270-71; see also Owensby & Kritikos, 819 F.2d at 1322-23. The amount of stock owned by a shareholder/employee is an indication of whether the employee negotiated his or her compensation at arms' length. See Northlick, Stolly, Inc. v. United States, 368 F.2d 272, 278 (Ct. Cl. 1966).



The taxpayer may assert that the fact that the minority shareholders approved s compensation suggests that his compensation was reasonable. See Heitz v. Commissioner, T.C. Memo. 1998-220, revs'd on other grounds, sub nom, Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999) (explaining that the approval of the president's compensation by minority shareholders weighs in favor of reasonableness of compensation, where minority shareholders "did not receive a substantial dividend or some other benefit as well."). Here,





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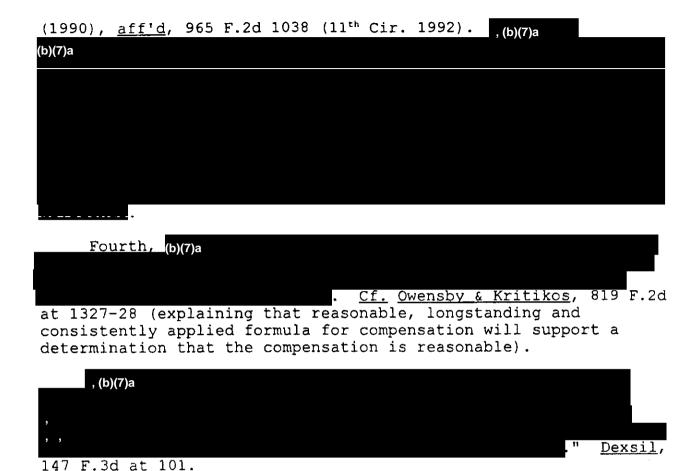
. Normandie, T.C. Memo.

2000-102. See also, Petro-Chem Mktg. Co. v, United States, 602

F.2d 959, 968 (Ct. Cl. 1979); Owensby & Kritikos, 819 F.2d at

1329; Estate of Wallace v. Commissioner, 95 T.C. 525, 555-56

(b)(7)a



#### 3. Internal Consistency in Compensation

Courts look to the internal compensation policies relating to non-shareholder employees to determine whether the corporation has compensated its shareholders more favorably because of their ownership interests. H&A Int'l Jewelry, T.C. Memo. 1997-467. If an employer consistently pays its non-shareholder employees generously, this will support the reasonableness of the compensation paid to the shareholder employee. See Home Interiors & Gifts, 73 T.C. at 1162. If, however, an employer pays its non-shareholder employees conservatively, this weighs against the reasonableness of the compensation paid to the shareholder employee. See Standard Asbestos Mfg. & Insulating Co. v. Commissioner, 276 F.2d 289, 293 (8th Cir. 1960).

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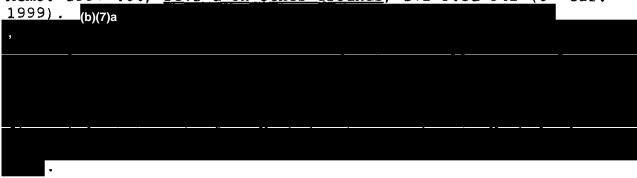


# 4. Character and Financial Condition of

The character and financial condition of bearing on whether the compensation paid to was reasonable. If the company is in good financial condition, then an independent investor would likely support 's payment of high compensation. Normandie, T.C. Memo. 2000-102. The character and financial condition of a company can be evaluated based on a company's "sales, net income, capital value, and general economic fitness." Id.

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Many courts examining this issue have evaluated the financial condition of a business based on the shareholder's return on equity for each year involved. See, e.g., Universal Mfg. Co., Inc. v. Commissioner, T.C. Memo. 1994-367; H&A Int'l Jewelry, T.C. Memo. 1997-467; Alpha Medical v. Commissioner, T.C. Memo. 1997-464, revs'd on other grounds, 172 F.3d 942 (6<sup>th</sup> Cir.

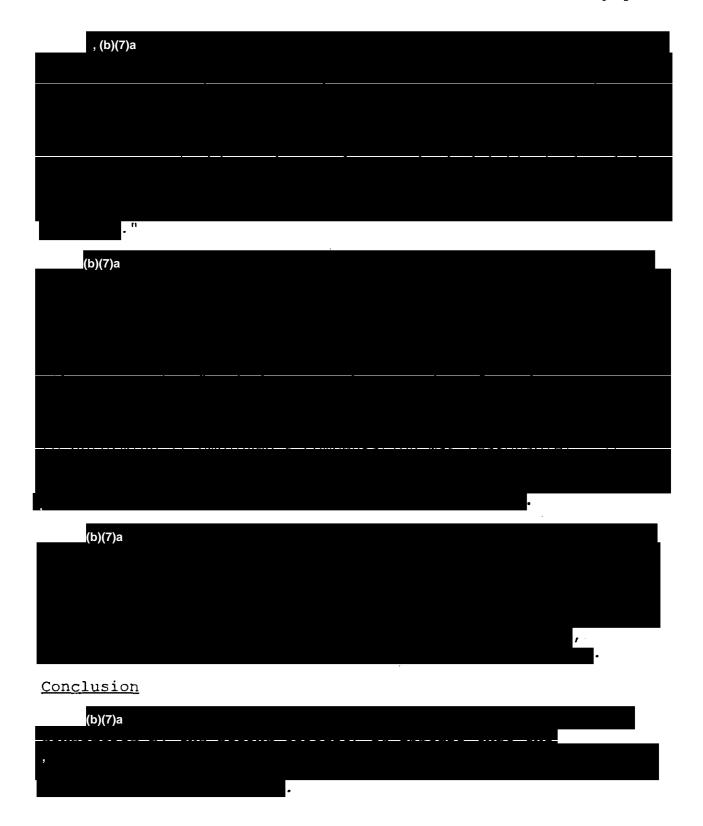


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." <u>Normandie</u>, T.C. Memo. 2000-102.

In addition, a corporation's failure to pay dividends may also suggest that the compensation it paid to a shareholder was unreasonable, when the compensation greatly decreases the corporation's rate of return for an independent investor. Elliotts, Inc., 716 F.2d at 1245; Automotive Investment Development, Inc. v. Commissioner, T.C. Memo. 1993-298. If a corporation does have a legitimate purpose for retaining large earnings, such as planned capital improvement or future growth, then its failure to pay dividends may not have any bearing on the reasonableness of the compensation. Owensby & Kritikos, 819 F.2d at 1326; Automotive Investment, T.C. Memo. 1993-298.

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5. Comparison of Compensation with Similar Companies	
Whether the compensation paid to and is reasonable also depends on the compensation similar companies pay to employees in similar positions with similar responsibilities. See Treas. Reg. § 1.162-7(b)(3); Rapco, 85	
F.3d at 954; Rutter, 853 F.2d at 1271; Mayson, 178 F.2d at 199;	
Normandie, T.C. Memo. 2000-102. (b)(7)a	İ



If you have any questions, please contact the undersigned at (212) 264-5475, extension 292, or Robin L. Peacock at (212) 264-1595, extension 289.

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